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FILED

MAR 10 1944

CHARLES ELMORE CROPLEY  
CLERK

IN THE  
**Supreme Court of the United States**

OCTOBER TERM, 1943

No. 777

NORTHWEST BANCORPORATION,

*Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

**PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS FOR  
THE EIGHTH CIRCUIT, AND BRIEF IN SUPPORT  
THEREOF**



## INDEX

<i>Petition:</i>	<i>Page</i>
Questions Presented .....	1
Statutes and Regulations Involved.....	2
Statement .....	5
Specification of Errors to be Urged.....	8
Reasons for Granting the Writ.....	8
<i>Brief in Support of Petition:</i>	
Opinions Below .....	14
Jurisdiction .....	14
Questions Presented, Statutes Involved, Etc.....	14
Argument .....	15
The Statutory Phrase "Amounts Which Can Be Distributed" Does Not Include the Taxpayer's Own Capital Stock.....	15
In Any Event, the Statutory Phrase "Amounts Which Can be Dis- tributed" Does Not Include Non-Taxable Stock Distributions.....	18
The Petitioner Was Prohibited by Contract from Making Non-Tax- able Stock Distributions .....	19

## CITATIONS

### Cases:

Page

<i>Bates Valve Bag Corp. v. Higgins</i> (D. C. N. Y.), 434 Commerce Clearing House, par. 9530.....	10-11
<i>Commissioner v. Columbia River Paper Mills</i> (C. C. A. 9th), 127 F. (2d) 558 .....	13
<i>Commissioner v. Oswego Falls Corp.</i> (C. C. A. 2d), 137 F. (2d) 173.....	11
<i>Helvering v. Northwest Steel Rolling Mills</i> , 311 U. S. 46.....	7, 9, 10
<i>Helvering v. Sprouse</i> , 318 U. S. 604.....	17
<i>Kaufmann Department Stores Securities Corp. v. Commissioner</i> , 2 T. C. 656 .....	11, 12
<i>Lynch v. Hornby</i> , 247 U. S. 339.....	16
<i>McCormick v. Market National Bank</i> , 165 U. S. 538.....	10
<i>Northwestern Steel &amp; Wire Co. v. Commissioner</i> , 1 T. C. 1114.....	10, 12, 19
<i>Oregon Pulp &amp; Paper Co. v. Commissioner</i> , 47 B. T. A. 772.....	11, 12
<i>Oswego Falls Corp. v. Commissioner</i> , 46 B. T. A. 801.....	11
<i>Paraport Theatre Leasing Corp. v. Commissioner</i> , 44 B. T. A. 108.....	11
<i>United States v. Dakota Tractor &amp; Equipment Co.</i> , 125 F. (2d) 20, certiorari denied, 316 U. S. 671.....	12, 13
<i>United States v. Stewart</i> , 311 U. S. 60.....	15
<i>Valentine-Clark Corporation v. Commissioner</i> (C. C. A. 8th), 137 F. (2d) 481, pending on petition for certiorari, No. 644, October Term 1943 .....	10, 12, 16
<i>Valentine-Clark Corporation v. Commissioner</i> , 46 B. T. A. 821.....	11
<i>Woolford Realty Co. v. Rose</i> , 286 U. S. 319.....	17

### Statutes:

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 14 (a) (1) and (2).....	2
Sec. 14 (b) .....	2
Sec. 26 (c) (1), (2), and (3).....	1, 3, 4, 5, 7, 8, 9, 15, 16, 18, 19
Sec. 115 (a) .....	4, 16, 18, 19
Sec. 115 (f) (1) .....	2, 4, 9, 16, 18, 19
Sec. 115 (h) (2) .....	4, 19

Revenue Act of 1942, c. 619, 56 Stat. 798:

Sec. 501 (a) .....	16
--------------------	----

### Miscellaneous:

Congressional Record, Vol. 80 .....	16
H. R. 12395, Sec. 15 (a), 74th Cong., 2nd Sess.....	16
S. Rep. 1631, 77th Cong., 2nd Sess., p. 245.....	16
Treasury Regulations 94, Art. 26-2 (b) (1) and (2).....	5, 19

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**PETITION**

Northwest Bancorporation prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Eighth Circuit entered in this cause on February 16, 1944 (R. 46), reversing the decision of the Tax Court of the United States (R. 16-28).

**QUESTIONS PRESENTED**

1. Whether, as respects the credit by reason of contracts restricting the payment of dividends given by Section 26 (c) (1) of the Revenue Act of 1936 for purposes of the surtax on undistributed profits, the phrase "amounts which can be distributed" in said section includes only the taxpayer's

assets or whether it includes also shares of the taxpayer's own capital stock.

2. If the latter construction be correct, whether credit is to be denied under said provision where only one class of stock is authorized by the taxpayer's charter and it is provided by Section 115 (f) (1) of said Act that a non-taxable distribution "shall not be treated as a dividend".

### STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 14. *Surtax on Undistributed Profits.*

(a) *Definitions.*—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

\* \* \* \* \*

(2) [as amended by Section 501 (a) (1) of the Revenue Act of 1942, c. 619, 56 Stat. 798] The term "undistributed net income" means the adjusted net income minus the sum of (A) the dividend paid credit provided in section 27, (B) the credit provided in section 26 (c) relating to restrictions on payment of dividends, (C) except in cases where section 26 (c) (1) is applicable, the deficit credit provided in section 26 (f), and (D) the redemption credit provided in section 26 (g).

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net

income which is not in excess of 10 per centum of the adjusted net income.

\* \* \* \* \*

Sec. 26. *Credits of Corporations.*

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

\* \* \* \* \*

(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

(3) *Double Credit not Allowed.*—If both paragraph (1) and paragraph (2) apply, the one of such paragraphs which allows the greater credit shall be applied; and, if the credit allowable under each paragraph is the same, only one of such paragraphs shall be applied.

Sec. 115.

(a) *Definition of Dividend.*—The term “dividend” when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

\* \* \* \* \*

(f) *Stock Dividends.\*\**

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

\* \* \* \* \*

(h) *Effect on Earnings and Profits of Distributions of Stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities \*\*\* shall not be considered a distribution of earnings or profits of any corporation—

\* \* \* \* \*

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution \*\*\*.



Regulations 94, promulgated under the Revenue Act of 1936:

Art. 26-2.

(b) Prohibition on payment of dividends.—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends. If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year), without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

### STATEMENT

The petitioner is a corporation organized under the laws of Delaware. Its principal place of business is in Minneapolis, Minnesota. It is engaged chiefly in owning and holding shares of common capital stock in banks and other financial institutions, and, in addition, in rendering to them various compensated supervisory services. One of such institutions is Union Investment Company. (R. 17.)

On December 30, 1933, the petitioner and Union executed

an agreement in consideration of a loan to Union by Reconstruction Finance Corporation, and of the purchase by RFC of shares of preferred stock or capital notes or debentures in certain banks in which the petitioner owned common shares; such banks were in the agreement referred to as "unit banks". (R. 17-18.) The agreement contained the following paragraph (R. 19):

Fifth. Northwest Bancorporation will not, without the prior written consent of RFC, declare or pay any dividends (except stock dividends) upon any of its outstanding shares of capital stock unless and until:

\* \* \* \* \*

(C) the sound value of the assets representing the Common Capital in each of the Unit Banks, determined as hereinbefore provided in Paragraph Third, shall be equal to at least 150 percent of the outstanding aggregate par value of the preferred stock, and/or the aggregate face amount of capital notes or debentures of each of the unit banks.

The loan and purchases were made, all of them on or before September 30, 1934. (R. 19-20.)

While the loan had been repaid in full and the purchased preferred shares and capital notes and debentures had to a substantial extent been retired by the end of 1936, such shares and obligations were still held by RFC in certain banks whose assets during 1936 were not of a value as great as that specified in condition (C) of Paragraph Fifth of the agreement. (R. 20, 22.) By letter dated December 9, 1936, RFC notified the petitioner, in answer to a written inquiry from the latter, that it withheld consent to the petitioner's paying any dividends. (R. 5-8, 23.)

During 1936 and 1937<sup>1</sup> the petitioner's authorized capital stock consisted only of 2,000,000 common shares, of which

<sup>1</sup>At issue is 1937 as well as 1936, the respective amounts involved, exclusive of interest, being \$130,940.18 and \$73,718.84. (R. 16, 28.) While both years were before the Tax Court, it has been agreed that proceedings as to the later year shall be suspended until final decision has been rendered as to 1936.

1,679,501 shares were issued; of the latter a minimum of 92,453 and a maximum of 102,066 were held in the petitioner's treasury. The smallest number of shareholders during these years was 17,660, with individual holdings ranging from one share to 15,540 shares, the smallest maximum individual holding at any one time being 15,000 shares. (R. 20-21.)

For purposes of the surtax on undistributed profits, the petitioner in its return, by reason of the restriction imposed by Paragraph Fifth of the agreement of December 30, 1933, claimed a credit under Section 26 (c) (1) of the 1936 Act equal to its adjusted net income. The respondent disallowed the credit, on the ground that the contract did not prohibit payment of taxable stock dividends, and determined a deficiency accordingly. (R. 23-24, 10-12.) The Tax Court reversed, on the ground that the petitioner could have paid only non-taxable stock dividends and that ability to pay such dividends does not preclude allowance of the credit. (R. 27-28.) The Circuit Court of Appeals in turn reversed the Tax Court, restoring the respondent's determination. (R. 43.) However, it did so for reasons different from that of the respondent; it held that the credit was not allowable if the taxpayer could have paid any kind of stock dividend, whether taxable or not, and that, in any event, lack of authority to pay taxable stock dividends was due to the limitations of the taxpayer's charter, and hence was the result of a non-contractual prohibition within the doctrine of *Helvering v. Northwest Steel Rolling Mills*, 311 U. S. 46. (R. 35-42.)

## **SPECIFICATION OF ERRORS TO BE URGED**

1. The Circuit Court of Appeals erred in holding that the phrase "amounts which can be distributed" in Section 26 (c) (1) of the Revenue Act of 1936 includes shares of the taxpayer's own capital stock.

2. The Circuit Court of Appeals erred in holding that the word "dividends" in said Section 26 (c) (1) includes non-taxable distributions of shares of the taxpayer's own capital stock.

3. The Circuit Court of Appeals erred in holding that where a contract provides that a corporation may not "pay any dividends (except stock dividends) upon any of its outstanding shares of capital stock" and the corporation has only one authorized class of capital stock, inability of the corporation to pay a dividend taxable to its shareholders is not the result of a prohibition imposed by "written contract executed by the corporation" within the meaning of said Section 26 (c) (1).

4. The Circuit Court of Appeals erred in reversing the decision of the Tax Court.

## **REASONS FOR GRANTING THE WRIT**

1. The principal issue relates to the construction to be placed upon a United States tax statute, Section 26 (c) (1) of the Revenue Act of 1936, particularly the phrase "amounts which can be distributed \*\*\* as dividends". As such, it presents an important question of federal law which has not been, but should be, settled by this Court. It involves determination, first, whether the phrase refers only to asset-distributions—"dividends" in the commonly-understood meaning—, or whether it includes also distributions

of shares of the taxpayer's own capital stock. However, the latter interpretation, once adopted, raises the further question whether the phrase includes not only taxable stock-distributions but non-taxable ones as well, in view particularly of the fact that non-taxable stock-distributions are by Section 115 (f) (1) of the Act excluded from the technical definition of "dividends".

These questions have never been before this Court, and the course of the decisions in the lower courts indicates that their solution is not easy; indeed, the decision whose review is sought ~~in~~ points out (R. 39-40), so far as the second foregoing question is concerned, that the problem is a "formidable" one and that "there reasonably is room" for either of the opposing possible interpretations. There is need under the circumstances for a definitive construction by this Court.

2. It appears further that the Circuit Court of Appeals may have misinterpreted and misapplied this Court's decision in *Helvering v. Northwest Steel Rolling Mills*, 311 U. S. 46, a case involving Section 26 (c) (1). Therein it was said (p. 49):

True, obligations not set out at length in a written contract may be incorporated by specific reference, or even by implication. But Congress indicated that any exempted prohibition against dividend payments must be expressly written in the executed contract. \*\*\*

Notwithstanding that it was spoken in a case wherein there was no written contract within the meaning of Section 26 (c) (1), whereas the contrary is true in the present cause, the foregoing language was by the Circuit Court of Appeals interpreted (R. 41-42) as requiring it to hold that there was at bar no contractually-imposed prohibition upon the petitioner's payment of taxable stock dividends inasmuch as the contract drew no distinction between taxable and non-

taxable stock dividends, and lack of authority to pay the former became evident only upon examination of the petitioner's charter. The court construed the *Northwest Steel* decision as forbidding looking outside the express terms of the contract for the purpose of ascertaining what was covered by the language used therein.

It does not seem reasonable to suppose that the *Northwest Steel* decision was intended by this Court to lay down any such extreme doctrine where, as here, the requirement of a written contract is satisfied. For otherwise it would mean that had the contract at bar prohibited the payment of all dividends "except such stock dividends as are allowable under the debtor's charter", the courts would be helpless to determine the bounds of the exception. But if the courts could look at the debtor's charter in that case, they should be able to do so at bar; for the legal effect is the same, under the familiar rule that corporate contracts are to be read in the light of what is allowable under charter powers (*McCormick v. Market National Bank*, 165 U. S. 538, 550).<sup>2</sup>

3. The issue has been dealt with, from one angle or other and under varying facts, in more than a score of cases in the lower courts. While information is not available to us as to the number of cases now pending, it seems safe to assume that there are at least a half dozen. Pending before this Court on application for certiorari as No. 644 is *Valentine-Clark Corporation v. Commissioner* (C. C. A. 8th), 137 F. (2d) 481. Pending on appeal to the Circuit Court of Appeals for the Seventh Circuit is *Northwestern Steel & Wire Co. v. Commissioner*, 1 T. C. 1114. It has been announced that the Government will appeal from the decision in *Bates Valve Bag Corp. v. Higgins* (D. C. N. Y.), to be found at

<sup>2</sup>The Circuit Court of Appeals appears (R. 42) to have regarded the taxpayer's charter as not a part of the contract "by legal implication". This seems to conflict with what is said in the *McCormick* case and in the first sentence of the quotation made above from the *Northwest Steel* decision.

434 Commerce Clearing House, par. 9530, wherein, under facts legally parallel with those in the present cause, it was held that credit was allowable. We understand also that an appeal on the part of the taxpayer is likely in *Kaufmann Department Stores Securities Corp. v. Commissioner*, 2 T. C. 656, wherein, again under facts legally parallel with those in the present cause, the Tax Court came to a conclusion directly contrary to its conclusion in the present cause, and held that credit was not allowable.

4. While it appears that at present the only decision in conflict with the decision sought to be reviewed is that in the *Bates Valve* case, there has until recently been a continuing and persistent conflict between the view of the Tax Court and the view of the Circuit Court of Appeals for the Eighth Circuit. What is more important, however, is that the decided cases indicate quite clearly considerable diffidence and uncertainty on the part of the courts, if indeed they have not been guilty of floundering.

The issue was first dealt with by the Tax Court, which adopted and for a considerable period adhered to the view that credit is allowable though stock dividends are not prohibited if the taxpayer had charter authority to pay only taxable stock dividends. See *Paraport Theatre Leasing Corporation v. Commissioner*, 44 B. T. A. 108, and other cases cited in the Tax Court's opinion in this cause. (R. 26.) The Tax Court continued in this view until *Oregon Pulp & Paper Co. v. Commissioner*, 47 B. T. A. 772, in which it veered toward the contrary position.<sup>3</sup> Six months later, however, it

<sup>3</sup>The Tax Court had previously taken the contrary position in *Valentine-Clark Corporation v. Commissioner*, 46 B. T. A. 821. However, this was probably due to inadvertent oversight of the circumstance that all the taxpayer's authorized stock was outstanding. This fact was referred to in the Tax Court's findings (p. 825) but was not mentioned in its opinion.

On the very same day the *Valentine* case was decided the Tax Court came to an opposite conclusion in another case. *Oswego Falls Corporation v. Commissioner*, 46 B. T. A. 801, reversed on other grounds, *Commissioner v. Oswego Falls Corporation* (C. C. A. 2d), 137 F. (2d) 173. The opinions were of course written by different judges.

decided the instant cause and therein swung back to its original view. (R. 28.) This was but momentary, however, for two months thereafter, in *Northwestern Steel & Wire Co. v. Commissioner*, *supra*, it shifted again to the view taken in the *Oregon* case.

That the Tax Court was still uncertain as to what position it would finally take is evidenced by the fact that its opinion in the *Northwestern Steel & Wire* case did not indicate express disagreement with the Tax Court's original decisions; nor did the opinion in the *Oregon* case do so. Express overruling of the original decisions came on September 9, 1943, in the *Kaufmann* case, *supra*, wherein the Tax Court said that it had concluded to adopt the view of the Circuit Court of Appeals for the Eighth Circuit.<sup>4</sup>

The issue has been before the Circuit Court of Appeals for the Eighth Circuit three times—in *United States v. Dakota Tractor & Equipment Co.*, 125 F. (2d) 20, certiorari denied, 316 U. S. 671, in *Valentine-Clark Corporation v. Commissioner*, *supra*, and in the present cause. The Tax Court until its *Kaufmann* decision repeatedly expressed disagreement with the *Dakota* decision (see R. 27-28), and in its *Valentine* opinion the Eighth Circuit itself said (p. 484) that it was "not concerned here \*\*\* with the reasons advanced" in support of its decision in the *Dakota* case, thus in effect, if not expressly, repudiating the grounds for its original view. Moreover, the reasoning advanced in the instant case is quite different from that upon which the *Valentine* decision was rested. (Cf. 137 F. (2d) 483, the full paragraph in the second column, with R. 38-42.) Thus while the Eighth Circuit has been consistent as to result, it has regularly shifted ground in reaching that result.

<sup>4</sup>It is not entirely clear even now that the vacillation of the Tax Court is at an end. The *Kaufmann* decision is not a "reviewed" decision (see Section 1118 (b) of the Internal Revenue Code), and hence there may be room for doubt as to whether it represents the view of a majority of the Tax Court judges.



The precise issue has been before the Circuit Courts of Appeals in only one other case. *Commissioner v. Columbia River Paper Mills* (C. C. A. 9th), 127 F. (2d) 558. While the same result was reached as in the *Dakota* case, which was not mentioned, the principal ground advanced appears to be quite different from that given in any of the Eighth Circuit decisions; the right to a credit, the court said (p. 560), depends on whether the taxpayer is able to reduce its accounting surplus.

The vacillation and uncertainty revealed by the decided cases emphasizes the need for a definitive construction of the statute by this Court.

5. There are persuasive reasons for believing that the decision of the Circuit Court of Appeals may be in error, as that court itself acknowledges. The principal reasons are set out in the brief in support submitted herewith.

Wherefore it is respectfully submitted that the petition should be granted.

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